

WASHINGTON

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84-4019

CABINET AFFAIRS STAFFING MEMORANDUM

Date: 7/16/84 Number: 169033CA Due By: _____

Subject: Cabinet Council on Economic Affairs with the President

Tuesday, July 17, 1984 - 2:00 p.m. - Cabinet Room

ALL CABINET MEMBERS	Action	FYI		Action	FYI
Vice President	<input checked="" type="checkbox"/>	<input type="checkbox"/>	CEA	<input checked="" type="checkbox"/>	<input type="checkbox"/>
State	<input checked="" type="checkbox"/>	<input type="checkbox"/>	CEQ	<input type="checkbox"/>	<input type="checkbox"/>
Treasury	<input checked="" type="checkbox"/>	<input type="checkbox"/>	OSTP	<input type="checkbox"/>	<input type="checkbox"/>
Defense	<input checked="" type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
Attorney General	<input type="checkbox"/>	<input checked="" type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
Interior	<input type="checkbox"/>	<input checked="" type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
Agriculture	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Baker	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Commerce	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Deaver	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Labor	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Darman (For WH Staffing)	<input checked="" type="checkbox"/>	<input type="checkbox"/>
HHS	<input type="checkbox"/>	<input checked="" type="checkbox"/>	McFarlane	<input type="checkbox"/>	<input checked="" type="checkbox"/>
HUD	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Svahn	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Transportation	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Chapman	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Energy	<input type="checkbox"/>	<input checked="" type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
Education	<input type="checkbox"/>	<input checked="" type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
Counsellor	<input checked="" type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
OMB	<input checked="" type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
<u>CIA</u>	<input type="checkbox"/>	<input checked="" type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
UN	<input type="checkbox"/>	<input checked="" type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
USTR	<input checked="" type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
GSA	<input type="checkbox"/>	<input type="checkbox"/>	Executive Secretary for:		
EPA	<input type="checkbox"/>	<input type="checkbox"/>	CCCT	<input type="checkbox"/>	<input type="checkbox"/>
NASA	<input type="checkbox"/>	<input type="checkbox"/>	CCEA	<input checked="" type="checkbox"/>	<input type="checkbox"/>
OPM	<input type="checkbox"/>	<input type="checkbox"/>	CCFA	<input type="checkbox"/>	<input type="checkbox"/>
VA	<input type="checkbox"/>	<input type="checkbox"/>	CCHR	<input type="checkbox"/>	<input type="checkbox"/>
SBA	<input type="checkbox"/>	<input type="checkbox"/>	CCLP	<input type="checkbox"/>	<input type="checkbox"/>
			CCMA	<input type="checkbox"/>	<input type="checkbox"/>
			CCNRE	<input type="checkbox"/>	<input type="checkbox"/>

REMARKS: The Cabinet Council on Economic Affairs will meet with the President on Tuesday, July 17, 1984 at 2:00 p.m. in the Cabinet Room.

The agenda and background paper are attached.

RETURN TO:

☐ Craig L. Fuller
Assistant to the President
for Cabinet Affairs
456-2823 (White House)

☐ Don Clarey
☒ Tom Gibson
☐ Larry Herbolzheimer

Associate Director
Office of Cabinet Affairs
456-2800 (Room 129, OEOB)



L-300B

THE WHITE HOUSE

WASHINGTON

July 13, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER *RBP*

SUBJECT: Agenda and Paper for the July 17 Meeting

The agenda and paper for the July 17 meeting of the Cabinet Council on Economic Affairs are attached. The meeting is scheduled for 2:00 p.m. in the Cabinet Room. Attendance is limited to principals only.

The first agenda item is a review of the economic outlook. This review will place current economic conditions in the context of the last three years, outline the mid-year update to the official forecast, discuss the strength of the current expansion, and the outlook for the economy during the coming months. No paper will be circulated for this agenda item in advance of the meeting.

The second agenda item will be a review of the budget outlook. This will cover the most recent projections for spending and revenues during FY 1984 and FY 1985-1989 including the changes due to updating the economic assumptions, actual spending to date, and recent legislative action on the deficit downpayment plan. No paper will be circulated for this agenda item in advance of the meeting.

The third agenda item concerns federal credit policy. The Working Group on Federal Credit Policy will present its revised OMB Circular A-70 putting into effect the federal credit policy recommendations approved by the President at the January 12, 1984 meeting. A brief memorandum on "Controlling Federal Credit Assistance" and the revised A-70 circular are attached.

Attachments

THE WHITE HOUSE

WASHINGTON

CABINET COUNCIL ON ECONOMIC AFFAIRS

July 17, 1984

2:00 p.m.

Cabinet Room

AGENDA

1. Economic Outlook (CM # 109)
2. Budget Outlook (CM # 127)
3. Federal Credit Policy (CM # 113)

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THE WHITE HOUSE

WASHINGTON

July 13, 1984

MEMORANDUM FOR THE PRESIDENT

FROM: THE CABINET COUNCIL ON ECONOMIC AFFAIRS

SUBJECT: Controlling Federal Credit Assistance

At the January 12, 1984 meeting of the Cabinet Council on Economic Affairs you approved four Federal credit policy recommendations including one to revise OMB Circular A-70, a general statement of credit policy, consistent with five basic principles. We are pleased to report that Circular A-70, first issued in 1965, has now been revised in accordance with your decisions.

The Growth of Federal Credit

One of the major methods by which the Federal government intervenes in the economy is by allocating credit to certain favored borrowers and implicitly away from other borrowers. Federal credit activity grew rapidly during the 1970's. From 1974 to 1980 net direct Federal government loans grew 490 percent and guaranteed loans grew 207 percent. In 1980, almost \$1 out of every \$4 of net lending in the United States was loaned by the Federal government, guaranteed by the Federal government, or lent by a federally sponsored agency.

During the last three years the growth of Federal credit activity has slowed, and in some areas has been reversed. However, as with the effort to control the growth of Federal spending, restraining the growth of Federal credit activity remains an essential priority.

The Allocation of Federal Credit

Proponents of expanded Federal credit subsidies point to the good accomplished by directing more resources to particular activities. They rarely point out that non-favored borrowers lose from Federal credit programs. Favored borrowers get more credit, non-favored borrowers less; favored borrowers pay less for their credit, non-favored borrowers must pay more.

In general, Federal credit activity has allocated credit to the agricultural and housing sectors. Almost half of the direct loans made by the Federal government are in farm and rural programs. These programs support farm purchases and operations, as well as crop prices. Some of the farm programs also support home purchases in rural areas. Three-fourths of the guaranteed loan commitments made by the Federal government are for housing.

-2-


The general business and industrial sectors get relatively less in Federal credit assistance and consequently receive less total credit at a higher cost. Thus, existing credit policies tend to diminish the effect of the 1981 business tax cuts that were intended to enhance investment in plant and equipment.

Circular A-70

Revising Circular A-70 is not a panacea for the problems arising from the growth in Federal credit, nor a substitute for specific programmatic efforts. Issuing a revised circular will not, by itself, cause any existing credit subsidy to be curtailed or redirected.

The circular does, however, state several principles of sound credit policy that will serve as guidelines for evaluating existing programs and reacting to proposals for new programs. The revised circular implements the five principles you approved. It will:

- (i) Require credit legislative proposals to contain an explicit statement of any subsidies in direct or guaranteed loan programs;
- (ii) Require that interest rates on direct loans be related to market interest rates, and vary with market conditions, rather than remain at fixed levels which become outmoded when market realities change;
- (iii) Oppose providing Federal guarantees for federally tax-exempt obligations;
- (iv) Require those receiving Federal loan guarantees to pay for part or all of the expected Federal default liability on the guaranteed loans; and
- (v) Encourage risk sharing with the private sector by offering less than 100 percent Federal guarantees rather than the full guarantee frequently used now.


Donald T. Regan
Chairman Pro Tempore

221:84
CIRCULAR NO. A-70
July 13, 1984

TO THE HEADS OF EXECUTIVE DEPARTMENTS AND ESTABLISHMENTS

SUBJECT: Policies and guidelines for Federal credit programs

1. Purposes. This Circular establishes Federal Government policies and guidelines that agencies are to follow: (1) in proposing or reviewing legislation to establish or revise credit programs; (2) in reviewing existing credit program legislation and proposing changes in such legislation; (3) in evaluating Congressional and other proposals on credit; and (4) in reviewing existing credit programs and establishing or changing policies for managing those programs. The purposes of this Circular are:

a. to ensure the consistent application of sound financial principles to the design and administration of Federal credit programs;

b. to improve the efficiency and effectiveness of Federal credit programs;

c. to eliminate unnecessary and unintended costs to the Government and the misallocation of the Nation's resources;

d. to facilitate adjustment in the amount and terms of new extensions of credit assistance in line with changes in capital market conditions;

e. to ensure that credit costs and changes in credit costs are properly taken into account in the development and administration of Federal credit programs;

f. to establish certain consistent credit management principles for achieving the objectives of the programs;

g. to minimize disruption and impairment of private credit markets; and

h. to recognize that individuals and private financial institutions are and should be the primary source of credit.

2. Rescissions. This rescinds and replaces OMB Circular No. A-70, dated February 1, 1965.

3. Authority. This Circular is issued under the authority of the Budget and Accounting Act of 1921, as amended.

4. Coverage. The provisions of this Circular apply to all executive branch departments and agencies.

5. Definitions. The following definitions shall apply:

(No. A-70)

a. Agency. Any executive branch department or independent commission, board, bureau, office, agency, or Government-owned entity including regulatory commissions or boards, but not including agencies of the legislative or judicial branches of the Government.

b. Credit programs. Credit programs include programs that offer direct loans, loan guarantees, loan insurance, or financial contracts that are designed to support borrowing.

(1) Direct loans. A direct loan is (a) a disbursement of funds that is contracted to be repaid, with or without interest; (b) a direct Federal participation in loans privately made or held; (c) a purchase of private loans through secondary market operations; (d) an acquisition of guaranteed private loans in satisfaction of default or other loan guarantee claims; or (e) a sale of agency assets on credit terms of more than 90 days duration.

(2) Loan guarantee. A loan guarantee is a contingent liability of an agency. A guaranteed loan is: (a) any debt obligation on which the agency pledges to pay part or all of the loan principal and/or interest to a lender or holder in the event of default by the borrower; and (b) a direct Federal loan that an agency has sold under a guarantee or agreement to repurchase.

(3) Loan insurance. Loan insurance is a type of guarantee in which an agency pledges the use of accumulated insurance premiums to secure lenders against default on the part of borrowers. For the purposes of this Circular, "loan insurance" is considered to be a "loan guarantee" and the term "insured loan" is considered to be a "guaranteed loan."

For the purposes of this Circular's requirements pertaining to annual agency budget submissions and justifications to OMB, a guaranteed loan or insured loan financed by the Federal Financing Bank (FFB) shall be considered a direct loan.

(4) Financial contracts. A financial contract is any agreement or contract made by an agency, the primary purpose or result of which is to make private credit available, or available on more favorable terms, to a non-Federal entity by indirectly or directly assuming the risk involved. Included are financial contracts such as agreements to pay all or part of the principal or interest on the debt obligation of a non-Federal entity (debt service payments), financial lease agreements for assets, and project financing and repayment arrangements. For the purposes of this Circular, "financial contracts" shall be considered as "loan guarantees".

6. Applicability of Circular. The requirements of the Circular shall apply for all of the following purposes:

a. Legislation proposed or supported by agencies that would establish new credit programs.

b. Legislation proposed or supported by agencies for extensions, expansions, or amendments to existing credit programs.

c. Agency reports and testimony on pending legislation that pertain to credit programs. Agency reports and testimony on such legislation shall point out explicitly any inconsistencies with the policies and guidelines of this

(No. A-70)

Circular.

d. Agency budget justifications and submissions to OMB and the Congress.

e. Existing credit program legislation. Annual agency budget submissions and justifications to OMB and the Congress shall include explicit proposals to change existing legislation affecting their programs to bring the legislation into conformity with the policies of this Circular. When an agency deems that a change in such legislation is not desirable, the agency must submit as part of its annual budget submission and justification to OMB a separate justification for not proposing to conform the program to this Circular.

f. The management of credit programs and agency reports on the management of credit programs. Credit program management and regulation shall follow the policies prescribed by this Circular.

7. Policy. Federal credit programs are established to accomplish a wide diversity of objectives. Nonetheless, certain policies are paramount in the establishment or administration of credit programs. Agencies shall:

a. provide Federal credit assistance only when necessary to achieve clearly specified Federal objectives and only when credit assistance is the best means to achieve those objectives;

b. encourage and supplement private lending activity such that it is displaced to the minimal degree possible by agency programs;

c. administer explicit standards for use in periodically assessing the credit risk of new and existing direct loans and guaranteed loans. In administering existing loans, agencies shall follow standard definitions of defaults, loan write-offs, and aging notes receivable; and

d. manage credit programs in such a way as to assure maximum protection to the Government against unnecessary loss while achieving Federal objectives. These management procedures shall include uniform methods to determine the credit worthiness of loan applicants, both at the time of initial application and at any subsequent time when the established credit terms or conditions are changed. Agencies shall also provide for periodic management review of credit decisions.

8. Objectives of Credit Programs. Federal credit assistance is intended to meet national objectives by providing credit on more favorable terms than otherwise available from private sources. These national objectives should be specifically and clearly defined in proposals to establish or expand credit programs and in the materials submitted to Congress to justify these proposals. Program objectives shall specify whether the direct loan or loan guarantee program is intended:

a. to correct a capital market imperfection, which should be defined; and/or

b. to subsidize borrowers or other beneficiaries, who should be identified, when the need for a subsidy is related to their credit market activities.

(No. A-70)

The objectives of the direct loan or loan guarantee program are to be reviewed on an annual basis to ensure that changes in financial markets and the activities of private financial intermediaries, or changes in the status of borrowers and beneficiaries, are reflected in the operation of the direct loan or loan guarantee program. This should be done as part of an agency's annual budget submission, and the supporting analysis included in the budget submission materials.

In order to gauge the degree to which credit programs correct capital market imperfections or provide subsidies to borrowers, agency budget justifications submitted to OMB and the Congress, and where relevant, agency reports and testimony on proposed legislation shall be accompanied by analysis that includes, but is not limited to:

(1) A description of existing and potential private sources of credit (a) by type of institution and (b) with respect to availability and cost of credit to borrowers, including typical fees, interest rates, repayment schedules, and maturities.

(2) An explanation as to whether, and why, these private sources of financing and the terms and conditions of the financing they offer must be supplemented and subsidized.

(3) An explanation as to why the proposed subsidy would or would not redress the specific inadequate financing cited.

9. Choice of Credit Program Methods. When Federal credit assistance is necessary to meet a national objective, the primary choice is between direct loans and loan guarantees. The degree to which an agency enables borrowers to obtain financing on more favorable terms than otherwise available from private sources is the degree of the subsidy. The degree of subsidy necessary to achieve program objectives should govern an agency's choice of credit aid between a direct loan and a loan guarantee. It should also determine the form of the direct loan or loan guarantee and the terms on which the direct loan or loan guarantee is made available.

a. Direct Loans. Direct loans, depending on their financial terms and conditions, provide potentially greater subsidies to favored borrowers than loan guarantees. Direct loans usually offer borrowers lower interest rates and longer loan maturities than are available from private financial sources, even with a guarantee. The use of direct loan programs, however, displaces private financial sources and increases the possibility that the terms and conditions on which Federal credit assistance is offered will not reflect changes in financial market conditions. Therefore, direct loans should be used only when the intended degree of subsidy cannot be achieved by use of loan guarantees.

b. Loan guarantees. Loan guarantees have economic effects similar to those of direct loans in allocating credit to borrowers at more favorable terms. Loan guarantees may make credit available when private financial sources would not do so otherwise. When alternative private financing is otherwise available, loan guarantees make that credit available at more favorable terms. By removing part or all of the credit risk of a transaction, loan guarantees change the allocation of economic resources and thereby may

(No. A-70)

impose a cost on the economy.

c. Guarantees of tax-exempt obligations. Federal direct or indirect guarantees of debt obligations, the interest on which is exempt from Federal tax, are an inefficient means of allocating Federal credit because the tax revenue loss to the Federal Government is greater than the interest savings to the borrower. To preclude the possibility that Federal agencies will stimulate inappropriate guarantees of tax-exempt obligations, agencies shall: (1) not guarantee federally tax-exempt obligations; (2) not subordinate direct loans to tax-exempt obligations; (3) provide that effective subordination of a guaranteed loan to tax exempt obligations will render the guarantee void; (4) prohibit use of a Federal guarantee as collateral to secure a tax-exempt obligation; (5) prohibit Federal guarantees of loans funded by tax-exempt obligations; and (6) otherwise prohibit the linkage of Federal guarantees with tax-exempt obligations. Where a large degree of subsidy comparable to that provided by guaranteed tax-exempt obligations is justified, agencies should consider the use of direct loans in accordance with the principles of this Circular.

10. Principles of Federal credit policy and standards for implementation. Agency submissions prepared for the purposes of Section 6 ("Applicability of Circular") shall include the following provisions.

a. Direct Loan Programs. Agencies shall:

- (1) Provide an explicit statement of the subsidy. The Federal Government offers borrowers a subsidy whenever it makes credit available to borrowers on more favorable terms than otherwise available from private sources. This economic subsidy will be calculated by the agency by taking into account the cost of alternative private financing available to actual or potential borrowers for the transaction or types of transactions being, or proposed to be, financed by the agency. The alternative private financing should be directly referenced to a benchmark financial instrument. In some cases, the financial condition of the borrower or the risk of the transaction may mean that financing would not normally be available from private lenders. In these cases, after consultation with private lenders, agencies should use the benchmark financial instrument of the closest credit equivalent and add an appropriate percentage premium. The proper benchmark financial market instruments include those used by banks for business and consumer loans, residential and commercial mortgages, corporate and municipal bonds, and similar instruments in the U.S. capital market.

The subsidy calculation should be on a discounted basis. It should include not only the interest rate on both the agency's direct loan and a representative, fully private, alternative loan, but also typical fees and commissions, grace periods, loan amortization schedules, and loan maturities. All assumptions used in the calculation of the subsidy must be explicitly stated in agency budget justifications submitted to OMB and the Congress, and available for review. Attachment A explains the method to be used in calculating the subsidy.

- (2) Specify minimum interest rates to be charged by reference to a benchmark financial market instrument. The benchmark instrument should

(No. A-70)

be the same type of instrument used in the calculation of the subsidy. Benchmark financial instruments should be chosen so that characteristics of the instrument, such as its term to maturity, match the characteristics of the Government loan as closely as possible. It must be specifically cited and justified in agency budget justifications submitted to OMB and the Congress.

Interest rates on new direct loans shall be reviewed and, when market conditions have changed, adjusted at least quarterly by agencies to reflect corresponding changes in the market interest rate of the benchmark financial instrument. Interest rates on direct loans may be fixed or floating over the life of the loan, at agency discretion. The interest rate on the direct loans need not be equal to the interest rate of the benchmark instrument. When interest rates on new direct loans are intended to be below the interest rate of the benchmark instrument, the interest rate on the direct loan must be stated as a percentage of the benchmark rate.

A specific level of interest rate should not be cited in legislation or in regulation as the benchmark: such an interest rate would become outdated as soon as financial market rates changed. If financial market rates rise, the degree of subsidy would increase unintentionally, without oversight by either Congress or the Executive Branch. If financial market rates fall, the degree of subsidy would decrease unintentionally.

Specific language that agencies should submit for inclusion in legislation is provided in Attachment B.

b. Loan Guarantee Programs. Agencies shall:

- (1) Provide an explicit statement of the subsidy. The Federal Government offers borrowers a subsidy whenever it makes credit available to guaranteed borrowers on more favorable terms than otherwise available from private sources. This economic subsidy will be calculated by the agency by taking into account the cost of alternative private financing available to actual or potential borrowers for the transaction or types of transactions for which loan guarantees are being offered. The alternative private financing should be directly referenced to a benchmark financial instrument. In some cases, the financial condition of the borrower or the risk of the transaction may mean that financing would not normally be available from private lenders. In these cases, after consultation with private lenders, agencies should use the benchmark financial instrument of the closest credit equivalent and add an appropriate percentage premium. The subsidy calculation should be on a discounted basis. It should include not only the interest rate on both the guaranteed loan and a representative fully private, alternative loan, but also typical fees and commissions, grace periods, loan amortization schedules, and loan maturities. All assumptions used in the calculation of the subsidy must be explicitly stated in agency budget justifications submitted to OMB and Congress, and available for review. Attachment A explains the method that should be used in calculating the subsidy.

(No. A-70)

In some cases, private insurance or guarantee coverage may be available of a type similar to that offered by the agency against certain types of risks. Where such coverage is available, agency calculation of the economic subsidy shall take into account the types of risks covered by agency and private guarantees, the availability of guarantee coverage from both agency and private sources, the level of guarantee fees, the fair market value of collateral, and other similar criteria.

- (2) Set fees for guarantee coverage by reference to benchmark guarantee fees or insurance premiums charged by private financial intermediaries or other private sources. Agencies shall consider the level of fees or premiums charged by private sources for similar types of guarantee or insurance coverage for similar kinds of borrowers against similar types or risk. Agencies shall at least annually assess the costs of guarantee coverage available from private sources by identifying and surveying these sources. Agencies shall set their fees or premiums for guarantee or insurance coverage as a percentage of the benchmark guarantee fee or insurance premium. The benchmark guarantee or insurance fee must be specifically cited and justified in agency budget justifications submitted to OMB and the Congress. Where applicable, agencies shall charge fees at levels sufficiently high that the program does not significantly diminish or preclude the possibility that existing or potential private sources of guarantee or insurance coverage will develop.

As a secondary criterion in setting loan guarantee fees, or when benchmark guarantee or insurance coverage is not available, agencies should set fees at a level sufficient to cover the total administrative and servicing costs of the loan guarantee program, and all or a portion of the estimated costs to the Government of the expected liabilities incurred under the guarantee, i.e., the cost of default. In loan guarantee programs where the agency does not consider it appropriate to charge borrowers a loan guarantee fee that provides for full recovery of estimated default costs, the agency must nonetheless estimate explicitly the full cost of the expected liabilities incurred under the loan guarantee and prescribe the percentage of these liability costs the Government is expected to recover.

Agencies shall at least annually estimate the expected administrative and servicing costs of the loan guarantee program, and, separately, the degree to which the contingent liabilities of the loan guarantees offered by the program may become actual Government liabilities. The degree to which contingent liabilities become actual liabilities will vary over time. Guarantee programs whose fees recover only a portion of expected default costs should be reviewed at least annually, and adjusted as necessary to recover the prescribed percentage of the estimated cost to the Government of expected liabilities. Assumptions used in the estimation of administrative servicing costs, and of potential liability should be stated explicitly in agency budget justifications submitted to OMB and Congress.

Specific language for inclusion in legislation is provided in Attachment B.

- (3) Encourage risk-sharing between private lenders and the Government, i.e., co-insurance. Loan guarantees that cover 100% of credit risk will encourage private lenders to exercise less caution than they otherwise would in evaluating loan requests from guaranteed borrowers. Such guarantees may provide unnecessary and unintended benefits to guaranteed borrowers. To prevent these possibilities, in general, loan guarantees should be structured so that private lenders bear a significant portion of the risk of loss from a default. "Significant" is defined as equal to or greater than 20 percent of the loss stemming from default.

The Government's claims on assets shall not be subordinated to other lenders in the case of a guaranteed borrower's default. Subordination increases the value of the guarantee to the borrower and may enable the borrower to raise additional amounts of credit on the strength of its collateral. Subordination increases the risk of loss to the Government, since other creditors have first claim on the borrower's assets. Therefore, the Government should have equal or superior standing with respect to other lenders.

- (4) Encourage the most efficient financing of guaranteed loans in a manner that does not expand the subsidy to borrowers. Guarantees of the timely payment of 100 percent of the loan principal and interest against all risk create a debt obligation that is the credit risk equivalent of a Treasury security. Accordingly, a Federal agency other than the Department of the Treasury may not issue, sell, or guarantee an obligation of a type that is ordinarily financed in investment securities markets, as determined by the Secretary of the Treasury, unless the terms of the obligation provide that it may not be held by a person or entity other than the Federal Financing Bank (FFB) or another Federal agency. The Secretary of the Treasury may waive this requirement with respect to obligations that the Secretary determines (1) are not suitable investments for the FFB because of the risks entailed in such obligations; or (2) are or will be financed in a manner that is least disruptive of private financial markets and institutions. The benefits of using the FFB must not expand the degree of subsidy. Attachment C lists the agencies and obligations covered by this requirement as of the issue date of this Circular.

In cases where the guaranteed loan is not financed through the FFB, agencies should ensure there is maximum competition among potential lenders for the financing of the guaranteed loan. Loan guarantees should be provided in a manner that allows borrowers a competitive choice among lenders.

Loan assets are direct loans that an agency has made to the public and on which repayments are still owed. Selling loan assets to the public with a Government guarantee is a form of federally assisted borrowing from the public. Guaranteed loan asset sales, however, are an inefficient means of borrowing for the Government, since purchasers of these guaranteed loan assets frequently offer prices well below the face value of the loans, despite the agency guarantee. For this reason, loan assets should not be sold to the public with an agency

guarantee or other recourse to the agency.

11. Legislation. In addition to the above requirements for existing and proposed legislation supported by the agency, legislation dealing with either direct loans or loan guarantees will:

- a. Allow for credit assistance to any prospective borrower only when it is necessary to alleviate a credit market imperfection or to achieve specified Federal objectives related to credit markets, and when it is the most efficient way to meet those objectives on a borrower by borrower basis;
- b. Require an equity interest by the borrower in any asset being financed with the credit assistance (i.e., a loan-to-asset value ratio that is less than 100%);
- c. Provide for maturities that are shorter than the estimated useful economic life of any assets financed;
- d. Provide for contractual agreements necessary to protect the Federal Government's interest; and
- e. Require that the maximum amounts of direct loan obligations and guaranteed loan commitments to be made be specifically authorized in advance in annual appropriation acts.

12. Exceptions to standards. In cases of existing legislation not in conformity with the policies of this Circular, agencies in their annual budget submission and justification to OMB and the Congress shall propose language to correct the inconsistency. When an agency does not deem a change in existing legislation to be desirable, it shall provide a separate justification for retaining the existing non-conforming legislation in its annual budget submission and justification to OMB.

In exceptional cases where, in the opinion of the agency, any requirement of this Circular, including its Attachments should not apply, the agency shall request the Office of Management and Budget, in writing, to modify or waive the requirement. Such requests shall include an identification of the modification(s) or waiver(s) requested, as well as a statement of the reasons for the request and the time period for which the exception is required. Exceptions, when allowed, will ordinarily be granted only for a limited time, in order to allow for review.

The Office of Management and Budget will, upon written request, provide technical advice on proposed credit program provisions that would be exceptions or additions to the standards prescribed herein. This will avoid delays and help to assure consistency with Federal credit policies.

13. Applicability of Circular No. A-19. This Circular supplements, but does not supersede, the requirements applicable to all proposed legislation under Circular No. A-19

14. Policy Review. The policies and procedures contained in this Circular shall be reviewed by the Office of Management and Budget within three years of

(No. A-70)

the date of issuance.

15. Effective Date. This Circular is effective immediately.

16. Inquiries. Further information on the credit policies in this Circular may be found in the Supplemental Report on Federal Credit Policy. Additional information on credit management procedures will be found in a forthcoming OMB Bulletin on such procedures.

For information concerning this Circular, contact the Office of Management and Budget, Fiscal Analysis Branch, Room 6026, New Executive Office Building, 726 Jackson Place, N.W., Washington, DC 20503.

David A. Stockman
DIRECTOR

Attachments

(No. A-70)

Attachment A to Circular A-70

MEASURING THE SUBSIDY ELEMENT OF FEDERAL FINANCING

The subsidy should measure the difference in cost to the borrower between the Government direct loan or guaranteed loan and alternative private financing available to the same or similar borrower for a similar purpose. Where similar borrowers, for similar transactions, would not normally receive financing from private lenders, the agency shall consult with private lenders in estimating the interest rate necessary to secure private financing for the applicant. The loans compared may have different interest rates, maturities, fees, grace periods, disbursement schedules, and repayment schedules. All these differences can and should be captured in a present value cash flow analysis.

The subsidy model should evaluate all the terms of the alternative private financing, translate these terms to cash flows, and calculate the internal rate of return of these cash flows. This internal rate of return should then be used to discount the cash flows associated with Government financing. The present value of the Government direct loan or guaranteed loan cash flows is the subsidy value of the Government direct loan or guaranteed loan.

The subsidy calculation would require the following sort of information about both the Government direct loan or guaranteed loan and the alternative private loan:

- (1) Interest rates.
- (2) Commitment fees or similar fees charged as a percentage of the undisbursed amount of the loan.
- (3) Other fees that are calculated as a percentage of the outstanding principal balance of the loan.
- (4) Any flat fees, such as transaction or application fees, that are either fixed dollar amounts or a percentage of the total loan that is equivalent to a flat amount.
- (5) Grace periods during which interest payments, but no principal payments, are due on the loan.
- (6) Loan maturity, or time allowed for repayment of principal after the grace period.
- (7) The disbursement schedule of the loan, or the amounts of principal that are given to the borrower in different time periods.
- (8) The schedule of payments of principal and interest over the maturity period.

(No. A-70)

The cash flows of the private financing should be calculated given the terms of the private loan as to interest rates, fees, grace period, and other pertinent factors. The net cash flows of a given period would be equal to the amount of the loan principal disbursed in that period (cash inflow to the borrower) minus the amounts paid out for interest and fees and any principal repaid during the same period (cash outflow for the borrower). When the private loan's net cash flows have been estimated, the internal rate of return (IRR) of these flows must be calculated. The IRR is that interest rate which, when used to discount the net cash flows, results in a present value of zero. As an equation, the IRR is the value of r which satisfies the following expression:

$$\sum_{i=0}^n CF_i (1+r)^{-i} = 0$$

where n = number of periods the private loan is outstanding
and CF_i = net cash flow in period i .

The net cash flows of Government direct or guaranteed financing should then be calculated in a similar way as above, but using the terms of the Government direct or guaranteed financing as to interest rates, fees, grace period, and other pertinent factors. In the same way as just described, the net cash flow of a given period would be equal to the amount of the loan principal disbursed in that period (cash inflow to the borrower) minus the amounts paid out for interest or fees in that same period (cash outflow for the borrower). The net cash flow for each period calculated in this manner should be discounted to the present using as a discount rate the IRR of the cash flows of the private loan.

The present value of the subsidy (PV_{sub}) implicit in the Government direct loan or guaranteed loan would be equal to the sum of all net cash flows of the Government direct loan or guaranteed loan discounted to the present using the IRR of private financing as the discount rate (r). This present value expressed as an equation is:

$$PV_{sub} = \sum_{i=0}^m CF_i (1+r)^{-i}$$

where m = number of periods the Government direct loan or guaranteed loan is outstanding and
 CF_i = net flow in period i .

In most cases, payments of principal and interest are made more than once a year, so the period cash flows should be calculated on the same basis e.g., monthly, quarterly or semi-annually. Similarly, the value of r should be adjusted to reflect the terms of the payment schedule. For example, when payments are due twice a year, the cash flow period should be six months long, and both the interest and discount rates should be on a six-month basis.

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Attachment B to Circular A-70

MODEL CREDIT PROGRAM

A BILL

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,
That, this Act may be cited as "_____."

AUTHORIZATION

Sec. 2. The Administrator is authorized to make or guarantee loans to . . . (Define eligible applicants).

TERMS AND CONDITIONS

Sec. 3. Loans made or guaranteed under this Act shall be on such terms and conditions as the Administrator may prescribe, except that:

(1) The Administrator shall allow credit to any prospective borrower only when it is necessary to alleviate a credit market imperfection or to achieve specified Federal objectives related to credit markets, and when it is the most efficient way to meet those objectives on a borrower by borrower basis.

(2) Loans made or guaranteed shall provide for complete amortization within a period of not to exceed ____ years, or ____ percent of the useful life of any physical asset to be financed by the loan, whichever is less as determined by the Administrator.

(3) No loan made or guaranteed to any one borrower shall exceed ____ percent of the cost of the activity to be financed, or \$____, whichever is less as determined by the Administrator.

(4) No loan made or guaranteed shall be subordinated to other debt contracted by the borrower.

(5) No loan shall be guaranteed unless the Administrator determines that the lender is responsible and that adequate provision is made for servicing the loan on reasonable terms and protecting the financial interest of the United States.

(6) No loan shall be guaranteed if the income from such loan is excluded from gross income for the purposes of Chapter 1 of the Internal Revenue Code of 1954, or if the guarantee provides significant collateral or security, as determined by the Administrator, for other obligations the income for which is so excluded.

(7) Direct loans shall bear an interest rate that is set by reference to the average market yield to maturity (or interest rate) of a

(No. A-70)

benchmark financial instrument. The benchmark financial instrument shall be chosen through reference to the financing costs that unassisted borrowers of similar credit worthiness to typical borrowers in the program would incur in borrowing funds for similar purposes and under similar conditions as borrowers in the program. The minimum interest rate of these loans shall be (at) (no more than ___ percent below) the yield (or interest rate) of the benchmark financial instrument. The minimum interest rates of new loans shall be adjusted every ___ month(s) (weeks) (days) to take account of changes in the interest rate of the benchmark financial instrument.

(8) The approval of the Secretary of the Treasury shall be required of the interest rate, timing of issuance, source of financing, and substantial terms and conditions of the financing of guaranteed obligations, except that the Secretary of the Treasury may waive this requirement with respect to the financing of any guaranteed obligation when he determines that such financing does not have a significant impact on the market for Government and Government-guaranteed securities.

(9) Fees or premiums for loan guarantee or insurance coverage shall be assessed by reference to a benchmark guarantee fee or insurance premium charged by private sources for similar types of guarantee or insurance coverage for similar kinds of borrowers against similar types of risk. The minimum guarantee fee or insurance premium shall be (at) (no more than ___ percent below) the referenced benchmark guarantee fee or insurance premium, but not less than the guarantee fee or insurance premium set at a level sufficient to cover (i) the agency's costs for administering and servicing loan guarantees and (ii) ___ percent of the expected Government's net liabilities in the event the loan guarantees must be honored. Loan guarantee fees shall be reviewed every ___ month(s) (weeks) (days) to ensure that the fees assessed on new loan guarantees are at a level sufficient to cover the referenced percentage of the agency's most recent estimates of the Government's expected liability on guaranteed loans.

(10) Any guarantee made by the Administrator shall be conclusive evidence of the eligibility of the loan for such guarantee, and the validity of any guarantee so made shall be incontestable, except for fraud or material misrepresentation, in the hands of the holder of the guaranteed loan.

(11) The Administrator shall prescribe explicit standards for use in periodically assessing the credit risk of new and existing direct loans or guaranteed loans. The Administrator must find that there is a reasonable assurance of repayment before extending credit assistance.

(12) The total of any direct loan obligations or guaranteed loan commitments for the ___ program shall not exceed the limitations specified in appropriations acts.

PAYMENT OF LOSSES

Sec. 4(a). If, as a result of a default by a borrower under a guaranteed loan, after the holder thereof has made such further collection

efforts and instituted such enforcement proceedings as the Administrator may require, the Administrator determines that the holder has suffered a loss, the Administrator shall pay to such holder ___ percent of such loss, as specified in the guarantee contract. Upon making any such payment, the Administrator shall be subrogated to all the rights of the recipient thereof. The Administrator shall be entitled to recover from the borrower the amount of any payments made pursuant to any guarantee entered into under this Act.

(b) The Attorney General shall take such action as may be appropriate to enforce any right accruing to the United States as a result of the issuance of any guarantee under this Act.

(c) Nothing in this section shall be construed to preclude any forbearance for the benefit of the borrower which may be agreed upon by the parties to the guaranteed loan and approved by the Administrator.

(d) Notwithstanding any other provision of law relating to the acquisition, handling, or disposal of property by the United States, the Administrator shall have the right in his discretion to complete, recondition, reconstruct, renovate, repair, maintain, operate, or sell any property acquired by him pursuant to the provisions of this Act.

Attachment C to Circular A-70AGENCIES AND OBLIGATIONS SUBJECT TO
REQUIRED FINANCING BY THE FEDERAL FINANCING BANKAgency Debt

National Credit Union Administration -- Central Liquidity Facility
U.S. Export-Import Bank
U.S. Postal Service
U.S. Railway Association

Agency Loan Assets

Farmers Home Administration
Department of Health and Human Services -- Health Maintenance Organizations
Department of Health and Human Services -- Medical Facilities
Overseas Private Investment Corporation
Rural Electrification Administration
Small Business Administration

Government-Guaranteed Lending

Department of Defense -- Foreign Military Sales Credit
Department of Defense -- Defense Production Act
Department of Energy -- Geothermal Loan Guarantees
Department of Energy -- Non-Nuclear Act (Great Plains)
Department of Housing and Urban Development -- Community Development Block
Grant
Department of Housing and Urban Development -- New Communities
Department of Housing and Urban Development -- Public Housing Notes
General Services Administration
Department of Interior -- Guam Power Authority
Department of Interior -- Virgin Islands
National Aeronautics and Space Administration -- Space Communications
Company
Rural Electrification Administration
Small Business Administration -- Small Business Investment Companies
Small Business Administration -- State/Local Development Companies
Department of Transportation -- Section 511
Department of Transportation -- WMATA

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(No. A-70)